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Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In The Matter of	)	
	)	
Price Caps Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

COMMENTS OF THE TELECOMMUNICATIONS RESELLERS ASSOCIATION

The Telecommunications Resellers Association ("TRA"), through its undersigned counsel and pursuant to Section 1.415 of the Communications Rules, 42 C.F.R. § 1.415, hereby submits its comments in response to the Fourth Further Notice of Proposed Rulemaking in this proceeding, FCC 95-406 (released September 27, 1995) ("FNPRM").

I.

INTRODUCTION

These comments address the use of a Total Factor Productivity ("TFP") model in computing a productivity factor, or "X-Factor," to use in the long-term price cap formulas to be adopted by the Commission for regulation of certain rates of the local exchange carriers ("LECs") subject to price caps regulation, as well as certain other issues relating to the long-term price cap plan identified by the Commission in the FNPRM.

For the reasons set forth below, the Commission should not, as is proposed, adopt a TFP methodology based on total company productivity for use in the long-term price cap

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plan. The Commission regulates only local exchange carrier ("LEC") interstate rates, not all LEC rates. Assuming that LEC productivity in providing interstate access services exceeds LEC productivity in providing all services, which the record in this docket to date suggests,[1] the use of a TFP model based on LEC productivity for all services to calculate the X-Factor used in regulating interstate service rates would result in interstate rates that are artificially high and not reflective of actual economic conditions.

II.

ARGUMENT

A. A Total Company Total Factor Productivity Study Would Be Inappropriate For Adjusting The Price Cap Index For Interstate Rates.

In the First Report and Order in this proceeding,[2] the Commission tentatively concluded that the X-Factor in the long-term price cap plan should be based on a TFP study.[3] The Commission has identified three characteristics that X-Factor in the long-term price cap plan should possess. First, the X-Factor should be economically meaningful, *i.e.*, it should reliably measure the extent to which changes in LECs' unit costs have been less than the level of inflation. Second the X-Factor should ensure that LECs' reductions in

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1/ *See, e.g.*, Reply Comments of AT&T in CC Docket No. 94-1 (filed June 29, 1994) at 28-30.

2/ Price Cap Performance Review for Local Exchange Carriers, 10 F.C.C. Rcd. 8962 (1995) ("First Report and Order").

3/ First Report and Order at 9026-7. "Total Factor Productivity" is the ratio of an index of total outputs to an index of total inputs.

unit costs are passed through to consumers. Third, calculation of the X-Factor should be reasonably simple and based on accessible, verifiable data.[4/]

The TFP studies that have been submitted for the record in this proceeding lack these characteristics. For example, the TFP-based estimates of the X-Factor submitted by the United States Telephone Association ("USTA") in an earlier phase of this proceeding, which were based on total company productivity lacked the first characteristic identified by the Commission, *i.e.*, they did not provide a reliable measure of changes in LECs' unit costs for interstate services, because the data relied on in those calculations reflected productivity for all LEC services.[5/] As AT&T has pointed out, the appropriate X-Factor for interstate access must be higher than the TFP for all LEC services because demand for interstate access has grown more rapidly than demand for other LEC services, and LECs' interstate access services were more profitable than their intrastate services.[6/]

USTA's proposed TFP-based X-Factor calculation also fails to satisfy the second criterion stated by the Commission, because it does not ensure that the LECs' reduction in unit costs for interstate services are passed on to consumers. The X-Factor USTA computed -- 2.67%[7/] -- portrays a level of LEC productivity below that indicated by the Commission's initial choice of an X-Factor -- 3.3% -- a level which the Commission found to have inadequately reflected the LECs' productivity.[8/] Moreover, USTA's proposed

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[4/] FNPRM at ¶ 16.

[5/] FNPRM at ¶ 62 & n.78 (citing Reply Comments of AT&T, *supra*, note 1).

[6/] *Id.*

[7/] First Report and Order at ¶ 132.

[8/] First Report and Order at ¶ 19.

X-Factor was substantially lower (and therefore suggested much lower LEC productivity) than the X-Factors calculated by other commenters in this proceeding, which ranged from 5.0% to 5.9%.[9/]

Finally, USTA's TFP study relies on data that is neither accessible nor verifiable, thereby failing to satisfy the Commission's third goal for the X-Factor. For example, the study uses numerical values referred to as "Telephone Plant Indices," which are computed by the LECs using thus far unspecified data, and which the Commission has found are "not subject to external controls or validation."[10/] It is unclear whether the data necessary to compute these indices is publicly available, or whether it would be made available by the LECs. Such unverifiable, potentially inaccessible is inherently unreliable and should not be permitted to be used in calculating the X-Factor.

One of the Commission's objectives in adopting price cap regulation for the LECs was to simulate the efficiency incentives found in competitive markets.[11/] Price cap regulation was designed to force carriers to be more productive than they were under rate-of-return regulation, and to eliminate over time any inefficiencies inherent in the early price cap methodology as the LECs improved their productivity in response to the incentives provided by price cap regulation.[12/]

9/ First Report and Order at ¶ 102.

10/ FNPRM at ¶ 45.

11/ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 F.C.C. Rcd. 6786, 6790 ("LEC Price Cap Order").

12/ LEC Price Cap Order at 6816.

Because a TFP-based X-Factor calculated using productivity data for all LEC services would produce artificially high rates for interstate services that are not related to the economic costs of such services, and because such a methodology lacks the three characteristics the Commission seeks to achieve, the Commission should either calculate the X-Factor using an approach other than the TFP approach, or, if it elects to use the TFP model, it should base its calculations solely on data for the LECs' interstate services, and not for all LEC services.

In the First Report and Order, the Commission tentatively concluded that, because LEC interstate and intrastate services were largely provided over common facilities and because the record assembled by that point revealed no economically meaningful way to divide and measure the facilities used for interstate and intrastate services, the TFP used to set the X-Factor should be calculated on a total company basis.[13/]

In the Commission concludes that there is, in fact, no reliable way to distinguish the productivity of regulated interstate LEC services from intrastate and non-regulated LEC services, then the Commission should not attempt to approximate interstate TFP by using total company TFP. Because the price cap system caps only interstate rates, the long-term price cap plan must be based only on changes in LECs' interstate costs. The record apparently contains no evidence that the LECs' total company productivity is comparable to their productivity for interstate services only, and the Commission should not adopt an X-Factor based on total company operations unless it first determines that the result will reliably reflect LEC productivity for interstate services alone.

[13/] First Report and Order at ¶ 159; see FNPRM at ¶ 63.

The provision of interstate access services may use inputs less intensively than the provision of intrastate services. If the Commission intends to use a total company TFP methodology, it is obligated first to determine that total company productivity accurately reflects productivity for interstate services. Otherwise, the principal goals of the price caps system will not be fully realized, and the LECs will be better equipped to artificially inflate their rates at the expense of consumers.

B. The Commission Should Adopt Measures to Ensure that the LECs Price Services Nearer to Costs.

If the Commission elects to use the TFP methodology for calculating the X-Factor, it should re-visit the starting point rates that are used. When it initially adopted the price caps system, the Commission used as the starting point rates then-existing rates determined under rate-of-return regulation, with the idea that the incentives provided by price caps regulation would prompt the LECs to reduce their costs.[14/] The LECs, however, could reduce their costs without reducing their rates, unless the price caps system includes a mechanism to ensure that lower costs will translate into lower rates. Thus, the Commission should strive to identify and adopt measures to force access rates toward economic costs, and it should avoid measures that do not have this result.

For example, adoption of a rolling average method for updating the X-Factor, as proposed,[15/] would not drive rates toward economic costs, but would only reflect LECs' decisions as to how much to cut their costs. The LECs would have no incentive to cut costs under a rolling average method of updating the X-Factor. Therefore, the Commission

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14/ First Report and Order at ¶ 148.

15/ FNPRM at ¶ 96.

should determine the economic costs of services subject to price caps regulation and use those costs as a benchmark. In addition, the Commission should perform a Historical Revenue Study to determine whether the price caps system then in place is resulting in LEC productivity greater than the 11.25% that the LECs were permitted to earn as an industry under rate-of-return regulation.[16/] Such a study could be used to calculate the value of the X-Factor that would be necessary to maintain LEC earnings at 11.25% for the industry.

C. **The Commission Should Retain the Sharing Obligation for LECs Using the Lower Productivity Factor.**

The backstop sharing obligation for price cap LECs electing the lower productivity factor is an important safety valve in the system that helps encourage such LECs to price their services near cost.[17/] It accomplishes this by requiring LECs to pass through to their customers a portion of the gains they realize by reducing their unit costs.[18/] The Commission has determined that sharing works to adjust for imperfections in the X-Factor, such as when the X-Factor is substantially inaccurate or when LEC productivity varies substantially from the average.[19/] Unless compelling evidence is presented that the sharing obligation is no longer useful because it becomes possible to set the X-Factor at a perfectly accurate level, the sharing mechanism should be retained.

16/ First Report and Order at ¶ 167 & n.315.

17/ FNPRM at ¶ 112.

18/ *Id.*

19/ First Report and Order at ¶¶ 185, 193.

The reality is that it is unlikely that the X-Factor will ever accurately predict LEC productivity. Even the Commission's initial X-Factor had to be increased to more accurately reflect actual productivity. Until competitive pressures force rates down, the sharing mechanism should remain in place to ensure that consumers reap some of the benefits of LECs' productivity.

D. Neither the Productivity Factor Nor the Size of the Sharing Bands Should Vary To Reflect Competition.

The Commission is considering adjusting the X-Factor to reflect different levels of competition by geographic area.[20/] It is unlikely that productivity will decrease as competition develops. Absent strong evidence that the level of competition has an effect on productivity, no adjustment to the productivity factor should be made to reflect competition.

Similarly, NYNEX's proposal to link the size of the sharing bands to the level of competition each LEC faces[21/] should be rejected. First, the competitive checklist NYNEX has proposed reflects only removal of regulatory barriers to entry, not indicia of actual competition. Second, NYNEX's proposal would permit a LEC to increase earnings as competition increases, thereby denying consumers a major benefit of competition. LECs will likely reduce costs in response to competition; but if they are allowed to retain a greater share of the rewards from their increased productivity, the public will not realize

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20/ FNPRM at ¶¶ 109-110.

21/ FNPRM at ¶ 128.

the benefits it deserves. Thus, the size of the sharing bands should not be adjusted to reflect competition.

III.

CONCLUSION

The Commission should exercise caution in adopting a long-term methodology for calculating the productivity factor, and the approach that it adopts should reflect LEC productivity for interstate services, not for all LEC services. Because the LECs are more productive in the provision of interstate services, they will realize a windfall and ratepayers will not benefit from rates set near costs, if an artificially low productivity factor based on all LEC services is used.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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